



# JOINT ECONOMIC COMMITTEE

ROBERT F. BENNETT, VICE CHAIRMAN SEPTEMBER 15, 2005

## A Pension Primer

The current debate over the solvency of the Social Security system and the recent media coverage of terminated corporate pension plans has brought the issue of retirement security to the forefront. Indeed, legislation dealing with a myriad of pension issues is currently pending in both the House of Representatives and the Senate.

In order to fully comprehend the current pension debate, it is necessary to understand the basic types of pensions and other retirement savings vehicles. Given the inherently complicated nature of these plans, this is no small feat. This report, which is the first in a series of papers on pensions by the Joint Economic Committee's Vice Chairman's staff, provides some background on the different types of employer-sponsored pension plans in use today, a description of Individual Retirement Accounts and a discussion of recent trends. Additional JEC reports, which will explore various pension topics more in-depth, are forthcoming.

### *What Are the Different Types of Employer-Sponsored Pension Plans?*

Pensions plans offered by employers fall into one of two legal categories: *defined benefit (DB)* or *defined contribution (DC)*. Both types of plans have various federal tax benefits associated with them, provided that they meet certain requirements. Moreover, the federal government directly regulates the administration of both types of plans through the Employee Retirement Income Security Act of 1974, commonly referred to as *ERISA*.

#### *Defined Benefit Plans*

A defined benefit plan is what most American workers consider to be a traditional pension. In such a plan, a firm promises to provide a worker with a fixed monthly payment upon retirement, and the size of the payment depends on both the worker's earnings history with the company as well as the number of years the employee worked for the company. Monthly payments end with the death of the employee or the employee's spouse. An example of a DB plan is the Basic Benefit Plan portion of the Federal Employee Retirement System (FERS), which is offered to employees of the federal government.<sup>1</sup>

In a traditional DB plan, an employee accrues an annual pension benefit that is equal to the final average pay earned with a company over a certain time period (for example, the final three years of employment)<sup>2</sup> multiplied by the number of years of service with the company multiplied again by the rate at which benefits accrue, commonly between 1 percent and 2 percent per year. For example, let's say a company provides employees with a pension benefit based on average salary for the final three years of employment with the benefit accruing at a rate of 2 percent per year of service. An employee with 25 years of service and final average salary of \$50,000 would therefore receive an annual benefit of \$25,000 (\$50,000 x .02 x 25 years), or 50 percent of his final average salary. Typically, retirees supplement their reduced income with Social Security benefits and other savings.

<sup>1</sup> The Civil Service Retirement System (CSRS), which was replaced by FERS, is also an example of a DB plan.

<sup>2</sup> An increasingly common type of DB plan is a *cash-balance* plan. Cash-balance plans differ from traditional DB plans in that benefits are determined based on an employee's *career average pay* with the company rather than *final average pay*. Because of this difference, the employer's cost of funding a traditional DB plan generally increases steeply as an employee nears retirement age. Benefits in a cash-balance plan, however, accrue more evenly over an employee's tenure.

Firms usually place certain requirements on defined benefit pensions. For instance, employees may be required to work for the employer for a certain number of years before they qualify, or *vest*, in a pension. The number of years an employee is required to work for a company before they are eligible is called the *vesting period*. Also, as with Social Security benefits, an employee who retires before a minimum age may receive a smaller pension than had he or she retired at the normal retirement age, the rationale being that when an employee retires early, the firm can expect to make payments over a longer period of time.

Under ERISA, employers are required to fully fund the benefits of their DB plans. In order to be fully funded, the value of the plan's assets must be at least equal to the *present value* of the benefits that the company's employees have accrued.<sup>3</sup> To fund DB plans, employers make annual contributions to their pension plans. Annual funding requirements are determined based on actuarial forecasts of employees' age at retirement, length of service, final average salary and mortality rates. In addition to meeting funding requirements, firms must also pay insurance premiums to the Pension Benefit Guaranty Corporation (*PBGC*), the federal agency established under ERISA that is charged with protecting DB benefits.<sup>4</sup>

Defined benefit plans have a number of tax benefits associated with them, including the deduction of pension contributions from employer income, exclusion of employer contributions to pension plans from employee income and tax exemption of the earnings of pension trusts. However, pension payments are taxed as income when the employee receives them during retirement.

### *Defined Contribution Plans*

A defined contribution plan, on the other hand, is akin to a savings or investment account maintained by an employer on behalf of an employee. Typically, an employee elects to contribute a certain percentage of his or her gross income to the account each pay period. The employer will generally match the employee contribution up to a certain percentage of the employee's income. The contributions in the account are managed by the employee and are invested in stocks, bonds or other financial assets, depending on what investment options the employer's plan offers. When the worker retires, the retirement benefit is the balance in the account, which is the sum of all the contributions that have been made plus interest, dividends and capital gains (or losses). Unlike DB plans, the benefits of DC plans are not insured by the PBGC.

In the private sector, DC plans are commonly referred to as *401(k)* plans after the section of the Revenue Act of 1978 that created them. Similar plans include *403(b)* or *457* plans for non-profit and state and local government employers as well as *SIMPLE* plans for small business employers. The federal Thrift Savings Plan, or TSP, which is offered to federal government employees, is also a type of DC plan.

The chief tax benefit of a DC plan is that income taxes on contributions and account investment earnings are deferred until withdrawal. Paycheck contributions to these accounts are not taxed at the time the income is earned. However, when an employee withdraws funds from the account in retirement, the withdrawals, which are comprised of both contributions and investment returns, are taxed as income. Because contributions are made with pre-tax dollars, participants are able to increase the benefits of compounding.

Because of the tax benefit associated with DC plans, Congress placed a number of constraints on them. Most notably, an employee cannot contribute more than a certain amount to an account in a given year. Currently, the annual contribution cap is set at \$14,000. It will increase to \$15,000 in 2006 and be adjusted for inflation thereafter.<sup>5</sup> Furthermore, aside from certain exceptions,<sup>6</sup> an employee cannot withdraw from his DC plan

---

<sup>3</sup> The present value of a worker's pension benefits is essentially the equivalent of what the worker's benefits would be worth in today's dollars if paid in one lump sum.

<sup>4</sup> Further discussion of the PBGC and its role will be discussed in a later publication.

<sup>5</sup> Participants age 50 and older can make additional "catch up" contributions of up to \$4,000. This catch up contribution limit will rise to \$5,000 in 2006 and be indexed to inflation by \$500 increments thereafter.

<sup>6</sup> Exceptions include financial hardship due to medical expenses, purchase of a primary home or tuition for postsecondary education.

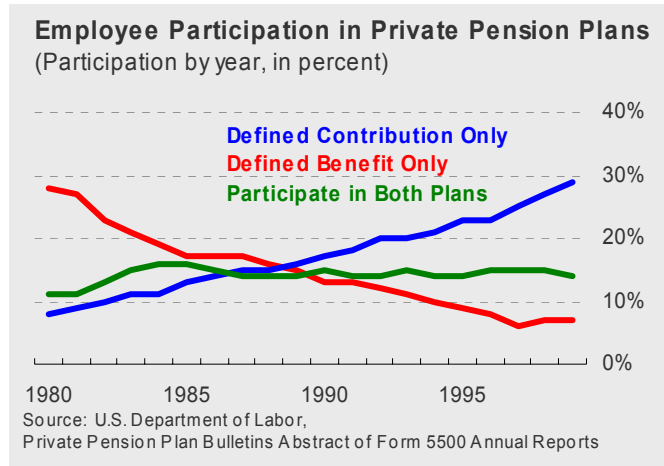
before reaching age 59½. Otherwise, the employee must pay a 10 percent tax penalty on the withdrawal in addition to regular income tax. Current law also requires that employees begin making minimum annual withdrawals after age 70½.

Employers also place constraints on DC plans. For example, firms often limit the choice of investment vehicles to a small number of funds. Companies also do not allow workers to contribute more than a certain percentage of their income, say 15 percent, to the account. Finally, companies usually have a vesting period associated with their matching contributions.

### ***What Are the Current Trends?***

In 1980, roughly half of all workers in the private sector participated in some kind of employer-sponsored retirement plan. Today, that percentage remains essentially the same.

However, what has changed substantially over this time period is the distribution of workers among the two types of pension plans. As the neighboring graph illustrates, there has been a gradual shift away from defined benefit to defined contribution plans as the retirement vehicle of choice. When DC plans were first established as an option in the late 1970s, many employers offered DC plans to supplement their DB plans. However, over time, many employers have chosen to sponsor only DC plans for their employees largely because such plans are significantly easier to administer and less costly to employers.



According to data from the Bureau of Labor Statistics, employees working for small businesses are much less likely to participate in an employer-sponsored retirement plan than are employees in large firms. Participation rates for men and women are roughly the same, but younger workers are less likely to participate than older workers. Moreover, workers with lower incomes are significantly less likely to participate in an employer-sponsored plan than those with higher incomes.<sup>7</sup>

### ***What Are Individual Retirement Accounts?***

Not all employees work for employers who offer a pension plan. And many other employees want to supplement their employer-sponsored pension and Social Security benefits with other retirement savings. For these workers, *Individual Retirement Accounts*, or IRAs, present an option to save for retirement on their own on a tax-favored basis.

Individual Retirement Accounts are essentially savings accounts but, due to their associated tax benefits, have some restrictions. IRAs come in two types: *traditional* and *Roth*.

#### ***Traditional IRAs***

Traditional IRAs were created in 1974 to promote retirement saving among workers who lacked employer pension coverage. Contributions to traditional IRAs, which are currently limited to a total of \$4,000 per

<sup>7</sup>*National Compensation Survey*, March 2005.

year, are tax deductible for the year the contributions are made.<sup>8</sup> The account is owned and managed by the individual and can be invested in stocks, bonds or other financial assets. Just as with a 401(k) plan, when funds are withdrawn in retirement, taxes are owed on both the contributions and the account's investment earnings.

In order to be eligible to make tax-deferred contributions to a traditional IRA, a worker must either lack employer pension coverage or have an adjusted gross income (AGI) below a certain amount. For 2005, the AGI cap for the full \$4,000 contribution is \$50,000 (\$70,000 for joint filers). The income cap is fully phased out at \$60,000 (\$80,000 for joint filers).

Similar to DC plans, with some exceptions, individuals cannot withdraw from an IRA prior to age 59½; otherwise, they will face a 10 percent penalty. Moreover, minimum withdrawals must begin starting at age 70½.

### *Roth IRAs*

Roth IRAs, which were created in 1997, are similar to traditional IRAs and have the same annual contribution limits. However, there are two key differences. First, eligibility is much broader for Roth IRAs. Regardless of whether an individual has access to an employer-sponsored plan, she can make full contributions to a Roth IRA as long as her AGI is less than \$95,000 (\$150,000 for joint filers). This limit is phased out for AGI of \$110,000 (\$160,000 for joint filers).

Second, contributions to Roth IRAs are made with *after-tax* dollars. In other words, the contributions are not tax deductible. However, when an individual withdraws funds from the Roth IRA in retirement, she does ***not*** have to pay income tax on her contributions or the account's investment earnings.<sup>9</sup>

The popularity of IRAs as a retirement savings vehicle has been growing steadily over time. From 1996 to 2003 the number of households owning an IRA of some kind nearly doubled from 29 million to over 45 million. Total IRA assets have also grown from \$637 billion in 1990 to roughly \$3 trillion in 2003.<sup>10</sup>

### ***Conclusion***

Committees in the House and Senate are considering legislative proposals both to encourage greater participation in defined contribution plans and to protect the benefits promised in defined benefit plans. In this context, the JEC will be releasing additional reports on relevant pension and retirement savings topics in the near future.

### **Other Pension Background Information Resources:**

Congressional Budget Office, [www.cbo.gov](http://www.cbo.gov)

Congressional Research Service, [www.crs.gov](http://www.crs.gov)

Government Accountability Office, [www.gao.gov](http://www.gao.gov)

Pension Benefit Guaranty Corporation, [www.pbgc.gov](http://www.pbgc.gov)

---

<sup>8</sup> This contribution limit will increase to \$5,000 in 2008. In addition, IRAs also permit catch up contributions for individuals age 50 and older. The current limit on catch up contributions is \$500 but will increase to \$1,000 in 2006.

<sup>9</sup> Roth IRAs are not subject to the minimum withdrawal requirement starting after age 70½. Moreover, the contributions to the Roth IRA -- but not the investment earnings on those contributions -- can be withdrawn from the account at any time without tax penalty.

<sup>10</sup> Survey by the Investment Company Institute